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2024 valuations – corporates and 'trapped surplus'

For schemes with a focus on insurance buy-out, trapped surplus can be a real area of concern for sponsoring companies. To reduce the risk of a trapped surplus, employers need a proactive approach that gives careful consideration to the legal complexities and the relationship between the employer and trustees.

Introduction

Following the unprecedented rise in the yields on government bonds over the past two years, a substantial proportion of UK defined benefit (DB) pension schemes now find themselves with a funding surplus.

In isolation, improved funding levels are great news for pension schemes. They've gone a long way towards securing the benefits of millions of members. However, many sponsoring employers, having paid deficit contributions for a number of years, don't have the appropriate plans in place to deal with or access any funding surplus.

Schemes with valuations in 2024 have an important opportunity to reflect on their current funding agreements with a view to ensuring the employer is well placed to deal with this risk in the future. Having a clear endgame can also help to mitigate this risk, although employers may not want to commit to a particular endgame now, given the legislative changes that are currently under discussion.

When is a surplus, really a surplus?

Many schemes have or are introducing a low dependency funding basis[1], which is stronger than their technical provisions[2], to reflect the direction of travel from the new funding code and as a stepping stone to an eventual endgame. So, being fully funded on your technical provisions may not be the end of the journey in terms of whether the trustees continue to seek contributions.

A surplus on a technical provisions basis may not be an issue if the scheme's endgame is to target an insurance buy-out, and the scheme is still some way away from that. Similarly, for those schemes where the employer's long-term objective is to target a run-on strategy, with a view to generating a surplus to provide value for both members and the employer, the idea of a trapped surplus is not likely to be relevant.

The term 'trapped surplus' refers to when an employer ends up with a surplus in its DB scheme but is unable to gain value from that surplus in one form or another (ie it is 'trapped') due to the rules, legislation or its current funding agreements with the trustees.

[1] A low dependency funding basis must use actuarial assumptions which are set such that, if one was to presume that the scheme was fully funded on that basis and the scheme's assets were invested in accordance with a low dependency investment allocation, then no further employer contributions would be expected to be required.

[2] A technical provisions basis is the amount needed to pay members' benefits in full as they retire, based on the scheme's approach for financing these benefits, and prudent financial and demographic assumptions.

Current routes for returning a surplus to an employer

In the current environment, a surplus can usually only be returned to the employer when it has been measured over and above the cost of an insurance buy-out. However, in practice, whether an employer can receive a return of such surplus depends on the rules. For instance, in some schemes, there are overriding trustee powers that allow the trustees to use surplus assets to augment members' benefits before any surplus can be returned to the employer. Under current legislation and scheme rules, many schemes are also only able to return a surplus to the employer at scheme wind-up, rather than on an ongoing basis.

The tax rate applied to any surplus returned to an employer was reduced from 35% to 25% from 6 April 2024, to align with the corporation tax rate for most companies.

The Department for Work and Pensions (DWP) is consulting on pension scheme surpluses. Proposals being considered include introducing a statutory override to make it easier to share surpluses between employers and members, and a statutory minimum threshold before a surplus can be shared.

This consultation could bring about significant change that would benefit scheme members and employers. But any changes are likely to take time to implement, which is why it's important for employers to give themselves maximum flexibility in any 2024 valuation negotiations.

Key considerations for 2024 valuations

For those schemes with 2024 valuations, it's vital that employers consider the use of surplus as part of the valuation negotiations. Common approaches that employers should be considering include:

- **Turn-off contribution mechanism:** if not already in place and the scheme is close to being fully funded on the technical provisions basis. We suggest funding triggers could be put in place, so deficit reduction contributions turn off once the scheme is fully funded based on the 'roll forward' estimates provided by the scheme actuary, say on a quarterly test.

  We have seen funding agreements in place for schemes with no such automatic switch-off. This can often mean that, if negotiations with the trustees prove to be difficult at an upcoming valuation, the employer has no leverage to stop contributions and has to provide a concession to the trustees before this can happen.

- **Escrow arrangements:** it may be worthwhile introducing an escrow arrangement to avoid potential issues from a trapped surplus. An escrow account can be setup so that, upon reaching a certain funding trigger, cash contributions are deposited into the escrow rather than the scheme. This gives security to the trustees that, in the case of any funding deterioration, the escrow can act as a cash injection.

  On the other hand, it could provide the employer with flexibility and the reassurance that, if not needed, any surplus funds won't be trapped in the scheme. Overall, this is a solution that strikes a balance between the interests of employers and trustees.

- **Expenses and future service contributions:** a healthy surplus can also be used to cover ongoing expenses in a scheme if these are not already allowed for within the liabilities. It may be that expenses are currently met directly by the employer, in which case the employer can seek to change this, so they are met from the scheme. It's worth introducing this as a discussion point in the valuation, even if there is currently only a small surplus (or a deficit), as this presents an indirect method of obtaining value from a surplus.

  The same can obviously apply to the cost of future accrual for those schemes still open to DB accrual, or those with a defined contribution (DC) section that was established on the basis that a DB surplus can be used to cover future DC contributions.

In any valuation discussions, by ensuring that the funding level is monitored regularly, the employer will help avoid the situation where a surplus arises unexpectedly.

It's clearly important to take into account your own scheme's circumstances, including what's practically possible under the rules given the balance of powers between the employer and trustees. There are a number of legal complexities surrounding the use of a surplus, both within legislation and specific to scheme rules.

Conclusion

Some schemes will look to run-on beyond insurance buy-out funding. For these schemes, the risk of trapped surplus may be reduced but will still require careful thought. For schemes with a focus on insurance buy-out, trapped surplus can be a real area of concern for sponsoring companies.

Addressing the issue of 'trapped surplus' requires a proactive approach to be taken for 2024 valuation negotiations, even if there isn't a surplus at the current time. They need to carefully consider the legal complexities and the dynamics of the relationship between the employer and trustees.

Employers should focus on gaining value from any surplus that emerges.

They might do this through mechanisms in the schedule of contributions, using the surplus to pay for future accrual or expenses, or by switching off contributions or diverting them to an escrow. The aim is to provide a balance between security for trustees and flexibility for employers.

The DWP's consultation could bring about significant change, in the best interest of members and employers. But any change will take time to implement. If a potential trapped surplus isn't factored into valuation discussions now, employers could find themselves at a disadvantage.

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